Securities Investor Protection Corporation (SIPC): Basic Functions and Fairness and Adequacy Issues

January 20, 2011

Congressional Research Service
https://crsreports.congress.gov
R41599

CRS REPORT
Prepared for Members and
Committees of Congress

Summary

The Securities Investor Protection Corporation (SIPC) is a nonprofit, nongovernmental corporation that was established in 1970 through the Securities Investor Protection Act (SIPA) to protect securities investors in the event of a broker-dealer failure. Except as otherwise provided in SIPA, the provisions of the Securities Exchange Act of 1934 (1934 act) apply as if SIPA were an amendment to, and included as a section of, the 1934 act.

A court-appointed trustee generally presides over a SIPC member broker's liquidation and returns the remaining cash and securities to the firm's former customers. If the returned customer assets do not make customers whole, SIPC advances additional cash and securities to the customers. With the broad goal of helping to maintain investor confidence in the securities markets, SIPC has historically provided up to $500,000 per customer, of which up to $100,000 could be in satisfaction of claims for cash only (as opposed to claims for recovered securities). Signed into law on July 21, 2010, and in effect the next day, the Dodd-Frank Wall Street Reform and Consumer Protection Act (P.L. 111-203) expanded SIPC protection available for cash claims up to $250,000 of the maximum customer protection of $500,000.

The SIPC funds that are used for such customers derive from the SIPC Fund. The Fund's assets come largely from annual assessments on SIPC broker-dealer members, at a rate that has been adjusted by SIPC. From 1997 to 2009, SIPC charged a flat rate of $150 per member.

In September 2008, immediately before the start of the Lehman Brothers liquidation, the size of the SIPC Fund was $1.5 billion. Beginning in April 2009, following the commencement of large liquidations of firms like Lehman Brothers and Bernard L. Madoff Investment Securities LLC, SIPC re-instituted assessments on a percentage basis. At that time, the Fund stood at $1.6 billion. SIPC increased the SIPC Fund level target from $1 billion to $2.5 billion, and increased annual member assessments from $150 to 0.25% of each member's net operating revenue. On January 31, 2010, the size of the Fund reached a low point of $1.07 billion. As of August 31, 2010, the Fund stood at $1.31 billion. The Dodd-Frank Act increases from $1 billion to $2.5 billion the amount that SIPC can borrow from the Treasury Department if the SIPC Fund is insufficient, and it imposes a minimum assessment on SIPC members not to exceed 0.02% of the gross revenues from the securities business of each SIPC member.

The Madoff case drew public attention to a number of public policy concerns. One concern is that SIPA does not cover so-called indirect investors, individuals invested in investment pools such as family partnerships or pension plans (also known as "feeder funds"), who have SIPA coverage as single entities. Under SIPA, each feeder fund is treated as an individual investor whose maximum SIPC protection is $500,000. Investors in feeder funds are thus entitled to a prorated and hence diluted portion of the payment to such a fund. Various observers say this is unfair. H.R. 5032 (Ackerman, 111th Congress), which could be reintroduced in the 112th Congress, would have required SIPC to provide up to $100,000 worth of protection to indirect investors in Ponzi schemes, including those involving Madoff. In addition, under H.R. 6531 (Garrett, 111th Congress), which also could be reintroduced in the 112th Congress, a victim's losses would be determined by the last amount on the individual's account statement. Currently, trustees use the last statement minus any amounts that have already been withdrawn by a customer, which is another concern. This report will be updated as events warrant.

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Introduction

The Securities Investor Protection Corporation (SIPC) is a nonprofit, nongovernmental corporation created by Congress in 1970. SIPC ensures that customers recover cash and securities when its members-securities firms become incapable of performing their custodial obligations to their customers. There are roughly 5,000 SIPC-member firms.

The impetus for congressional action came during the late 1960s, when a marked rise in securities trading volume that exposed major inadequacies in the systems that processed securities trades and provided centralized clearing. A host of problems existed: bottlenecks and paralysis plagued the trade processing and there were significant accounting and reporting abuses. The subsequent stock market decline pushed many securities firms into financial difficulties and many firms merged, failed, or ceased operating. Some firms used customer property for their own trading, while others experienced procedural breakdowns in the managing customer accounts, resulting in customer losses of millions of dollars.

In 1970, to avoid a recurrence of these events and accompanying negative consequences for investor confidence in the securities markets, Congress enacted the Securities Investor Protection Act of 1970 (SIPA),[1] and significantly changed it via the Securities Investor Protection Act Amendments of 1978.[2] With SIPA's enactment in 1970, Congress created SIPC to recover and return customers' cash, stocks, and other securities when their brokerage firm closed due to bankruptcy or other financial problems. The Securities and Exchange Commission (SEC) has oversight over SIPC, which was established by SIPA, and its bylaws. SIPA also gives the SEC authority to review, disapprove, adopt, amend, or repeal SIPC's bylaws and rules.

SIPC, which is not a regulatory authority and is funded by securities broker-dealers, has a seven-member public board of directors. The Secretary of the Treasury and the Federal Reserve Board each appoint one, and the President appoints the remaining five, subject to Senate confirmation. Of the President's appointees, three must be from the securities industry and two must represent the general public. The latter become SIPC's chairman and vice chairman.

Under SIPA, any entity that is registered as a broker-dealer with the SEC under the Securities Exchange Act of 1934 or who is a member of a national securities exchange must be a SIPC member. Also under SIPA, members are required to pay an annual assessment to SIPC.

This report provides an overview of various issues related to SIPC, including policy issues highlighted by the Madoff fraud, SIPC reforms in the Dodd-Frank Wall Street Reform and Consumer Protection Act, and pending legislation.

SIPC's Basic Functions

With a mandate to help maintain investor confidence in the securities markets, SIPC provides protection to customers for missing securities and cash left with failed securities firms. It protects customer assets (securities and cash) against losses of up to $500,000 at the time of a firm's collapse. Under the Dodd-Frank Act (P.L. 111-203) enacted on July 21, 2010, up to $250,000 may be for cash losses, in contrast to the historical amount of up to $100,000. Noncash assets that are covered include stocks, bonds, notes, and mutual funds. Through SIPA, Congress designed SIPC

[1] P.L. 91-598, 84 Stat. 1636. Except as otherwise provided in SIPA, the Securities Exchange Act of 1934 (1934 act) applied as if SIPA were an amendment to, and included as a section of, the 1934 act.

[2] P.L. 95-283, 92 Stat. 249.

to oversee the recovery and distribution to customers of missing customer cash and securities. Customer cash and securities collected by the SIPA trustee administering the liquidation become part of a fund of customer property that is shared on a prorated basis by customers. Such securities will have been held by the broker for the customer in "street name" (the normal convention in which a security is held in the name of a broker on behalf of a customer).[3] Subject to statutory limits, SIPC then makes advances to the trustee out of the SIPC Fund so that the trustee can satisfy, in cash or securities, the remaining amounts of allowed-customer claims.

Typically, customer claims evolve through the following process: First, the SEC or a self-regulatory organization, such as the New York Stock Exchange or the Financial Industry Regulatory Authority (FINRA, the principal securities broker-dealer self-regulator), alerts SIPC when a SIPC member is in serious financial difficulty. Then the SIPC normally responds by filing an application or complaint in a federal district court to liquidate the firm. The court usually appoints a SIPC-designated trustee, although the SIPC will sometimes be the trustee when liabilities are limited and a collapse affects fewer than 500 customers. Once liquidation proceedings are moved to a U.S. bankruptcy court, the trustee notifies the firm's customers and attempts to sell or transfer customer accounts to viable SIPC members. To recover funds or securities owed them from the firm, customers must file claims, which the trustee either allows or denies. To the extent that failed firms are unable to fully satisfy allowed-customer claims, SIPC advances funds to up to the statutory amounts identified above. SIPC does not protect customers against losses in commodities, precious metals, derivatives, unregistered investment contracts or limited partnerships, or other transactions that are not defined as "securities" under SIPA.

For example, suppose a SIPC-member firm fails and goes through the liquidation procedure. Suppose that the failed firm has an aggregate total of $5 billion in allowed claims, and that the trustee has been able to recover $4.5 billion, or 90% of those claims, through the firm's assets. This means that 90% of each former client's allowed claim will be covered through assets that have been recovered from the firm. Now suppose that there is a former customer, Client A, who has an allowed claim for $5 million against the firm. In this SIPA customer proceeding, Client A would receive 90% of the $5 million claim, or $4.5 million, from assets recovered from the firm, and $500,000 from a SIPC advance, making the client whole. If, however, the claim was $6 million, Client A would receive 90% of that, or $4.5 million from the recovered funds and $500,000 from SIPC, for a total of $5.9 million This would leave the client with a total of $100,000 in uncovered losses.

The SIPC Fund and Member Assessments

The SIPC funds that are used to make advances for customers and to supplement the recovered assets to satisfy customer claims derive from what is known as the SIPC Fund, sometimes known as the SIPC reserves. The Fund is also used to cover the administrative expenses of liquidation proceedings to the extent the debtor's general estate is insufficient.

The Fund's assets come from interest on investments in U.S. government securities and an annual assessment on SIPC-member firms. Historically, the assessment rate has been periodically adjusted by SIPC's Board with the SEC's approval.

In the event that the SIPC reserves have become or threaten to become insufficient for carrying out SIPA's mission, SIPC has the authority to indirectly borrow up to $2.5 billion from the U.S. Treasury, an amount mandated by the Dodd-Frank Act, which replaced the historical amount of

[3] In the much less common instances in which a security is registered or about to be registered in an investor's name, all of the securities will be returned to that investor.

$1 billion. Formally, the SEC would borrow the funds from the Treasury and then would relend them to SIPC. Until recently, SIPC also had access to a $1 billion line of credit with a consortium of banks. During the 1970s, 1980s, and 1990s, SIPC members were subject to changing rates. The annual rates, which are the same for all members, fluctuated as SIPC's Board has reportedly attempted to meet declines in the Fund's balance with rises in the assessment rate so that years with high expenditures would be followed by higher assessments.[4] Members have alternately been levied an annual percentage of their revenues (which was as low as 0.065% during periods of the 1990s) or have been assessed flat fees, such as between 1997 and 2009, when each member paid a flat annual rate of $150, the statutory "maximum minimum."

The Fund's target level was initially established in 1970 by SIPA at $150 million. Through the years, due to inflation, changes in the securities markets and securities industry, and rising levels of perceived monetary risk to SIPC, the Corporation's Board set the Fund level well above the original $150 million. For example, in 1991, the board adopted a policy to increase the Fund to $1 billion by 1997, a level that was reached in 1996.

Between 1996 and 2001, the size of the SIPC Fund ranged between $1.0 billion and $1.2 billion. From 2002 to 2006, the Fund hovered in the $1.2 billion to the $1.4 billion range. In 2007, the SIPC Fund ranged from $1.4 billion to $1.52 billion. In 2008, the Fund peaked at $1.7 billion, then fell to slightly more than $1 billion in 2009.

By 2009, after the liquidations of Lehman Brothers and Madoff's firm,[5] the consortium of banks that provided SIPC with a line of credit informed the SIPC that the credit line was not being renewed. Subsequently, SIPC's Board decided on a $2.5 billion target for the SIPC Fund (more than double the existing $1 billion). In addition, the board decided that SIPC also needed to boost its line of contingency credit from the Treasury Department from $1 billion to $2.5 billion, a change that required a legislative act. In 2009, with the SEC's approval, the SIPC amended its bylaws to incorporate a $2.5 billion target for its Fund.[6] To reach the significantly higher target level, SIPC also increased its member assessments from a flat $150 annual rate for all members to a rate that is now 0.25% of each member's net operating revenue.[7]

One major criticism of SIPC's approach to funding the SIPC Fund through its current membership assessment protocol is that it does not price the assessments on a risk-adjusted basis in which members would be assessed in accordance with their perceived risk to SIPC. A practical concern is that the current system may result in SIPC effectively subsidizing and thus implicitly encouraging high-risk member broker-dealers.[8]

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[4] U. S. General Accounting Office, Securities Investor Protection Update on Matters Related to the Securities Investor Protection Corporation, GAO-03-811, July 2003.

[5] On December 11, 2008, the SEC sued Bernard L. Madoff and his firm, Bernard Madoff Investment Securities, LLC, for securities and investment advisory fraud in connection with an alleged Ponzi scheme that allegedly resulted in substantial losses to investors in the United States and other countries.

[6] Securities Investor Protection Corporation Modernization Task Force, *Adequacy of the SIPC Fund*, SIPC, June 2010, available at http://www.sipcmodernization.org/Topics/summary/Adequacy%20of%20Fund%20FINAL.pdf. In an extreme emergency, where the SIPC Fund is depleted to $100 million, under SIPA, not less than half of 1% of a member's gross revenues can be charged. The absolute maximum member assessment is 1% of a member's gross revenues.

[7] After the assessment increase, some larger broker-dealers firms claimed that they will be paying millions of dollars in SIPC assessments. Some smaller broker-dealers reportedly have expressed resentment that they were effectively "paying for Bernard Madoff." For example, see Dan Jamieson, "B-Ds Reel from Higher SIPC Fees," *Investment News*, August 9, 2009, available at http://www.investmentnews.com/article/20090809/REG/308099981.

[8] In 2003, SIPC hired a risk manager responsible for giving SIPC's board and senior management an ongoing analysis

Proposals to address this perceived problem include (1) giving SIPC a regulatory watchdog role with respect to members' safety and soundness, which would likely require a major rewriting of SIPA, and involve a bigger SIPC with a larger budget; and (2) requiring that SIPA be amended to require SIPC-member fees be risk-adjusted so that members who are seen to pose greater risks would be assessed accordingly, which would likely require an expanded SIPC and could raise questions over the accuracy with which broker-dealer firm risks can be assessed.[9]

The notion of a risk-based pricing system was criticized in a 2003 report by Fitch Risk Management, the credit rating agency, which SIPC had requested. The report argued that adopting a tiered fee schedule based on a member's perceived risk would pose two major problems: (1) to gauge fee levels for its members, SIPC would have to evaluate their creditworthiness, which could be a very costly exercise that lacks clear benefits; and (2) firms deemed to pose particular risks might experience significant stress as a result of the assessment, possibly contributing to their failure.[10]

Policy Issues Highlighted by the Madoff Case

On December 11, 2008, the SEC sued Bernard L. Madoff and his firm, Bernard L. Madoff Investment Securities LLC, for securities and investment advisory fraud in connection with allegations that a Ponzi scheme had resulted in substantial losses to investors in the United States and other countries.[11] The Madoff fraud case has generated interest in several controversial policy issues involving SIPC, including the following:[12]

Net Equity. SIPC officials, and the court-appointed Madoff trustee, have indicated that SIPA provides protection based on an investor's actual net investment, or net equity, which should represent the difference between an investor's invested cash minus the cash that was withdrawn from an account.[13] A number of Madoff's investors objected to this approach, saying that the

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of risk factors and exposures to the SIPC Fund.

[9] For example, see Testimony of Professor John C. Coffee, Jr. before the United States Senate Committee on Banking, Housing and Urban Affairs, *The Madoff Investment Securities Fraud: Regulatory And Oversight Concerns and The Need for Reform*, January 27, 2009.

[10] "Review of SIPC Risk Profile and Practices: The MJK Clearing Event, the Securities Lending Exposure, Risk Management Practices and Capital Requirements," *Fitch Risk Management*, January 31, 2003, available at http://www.sipc.org/pdf/SIPC_fitch.pdf.

[11] SEC, "SEC Charges Bernard L. Madoff for Multi-Billion Dollar Ponzi Scheme," press release, December 11, 2010, available at http://www.sec.gov/news/press/2008/2008-293.htm.

[12] As of January 7, 2011, the trustee for the Liquidation of Bernard L. Madoff Investment Securities LLC reported that it had made determinations for 16,137 claims of which 2,372 had been allowed. The trustee reported that determinations were still pending on 307 of the cases. The trustee reported that the amount of the allowed claims was $5.96 billion in value and that the amount that, which had been committed by SIPC was $783.2 million. This left about $577.8 billion in claims that exceeded the statutory limits of SIPC protection at that time. Available at http://www.madofftrustee.com/Status.aspx. About the same time, in December 2010, new reports were indicating that due to a number of large recoveries by the Madoff trustee, including a $7.2 billion settlement with the widow of wealthy Madoff investor Jeffrey Picower, the total amount of money available for compensating Madoff victims was slightly under $10 billion, much more than was originally projected at the start. As such, various observers suggested that this was an encouraging sign that for people who had most, if not all, of their savings with Mr. Madoff, at least some of that money would eventually be recovered. For example, see Diana Henriques, "Deal Recovers $7.2 Billion for Madoff Fraud Victims," *New York Times*, December 17, 2010.

[13] The Internal Revenue Service has provided a safe harbor for taxpayers to enable them to deduct losses from fraudulent investment schemes as "theft losses." Up to 95% of qualified losses from a fraudulent investment arrangement, calculated through detailed definitions and formulas, can be deducted if certain requirements and circumstances are satisfied. Investors who unknowingly invested in a Ponzi scheme, such as the Madoff investment

trustee should use the "last statement method" and simply look at the value of their portfolio on their last statement to calculate their net equity because that statement showed significant earnings on their initial cash investments. On March 1, 2010, a bankruptcy judge from the United States Bankruptcy Court for the Southern District of New York approved the trustee's net investment method of determining customer claims. In doing so, the court rejected the Madoff investors' contention that customer claims must be allowed in the amounts shown on final customer statements.[14] The decision has been criticized by various investors and members of Congress, including Representative Scott Garrett, chairman of the House Financial Services Committee Subcommittee on Capital Markets and Government-Sponsored Enterprises.[15] Siding with the trustee and SIPC, officials at the SEC, which filed a brief in support of the cash in/cash out method, argued that the Madoff customer account statements "showed the results of securities transactions selected by Madoff and 'executed' at prices calibrated after the fact to produce predetermined favorable returns, returns that were possible only because they were entirely divorced from the uncertainty and risk of actual market trading."[16] Among other things, H.R. 6531, which Chairman Garrett introduced in the 111th Congress and which could be reintroduced in the 112th Congress, would have amended SIPA to determine a customer's net equity based on the customer's last statement.

Indirect Investors. SIPA does not cover indirect investors. Known as "claimants without an account," these investors invested money with Madoff's operation through investment vehicles that included family partnerships, pension plans, 401(k) plans, hedge funds, and other broker-dealers. Reports indicate that North Americans who invested with Madoff did so largely as indirect investors via money managers, feeder funds, and other hedge funds.[17] SIPA defines a customer to be an entity who has direct investments with a failed broker-dealer, which means that many indirect investors are not eligible for the $500,000 SIPC protection. They are only eligible for a diluted, prorated portion of the $500,000 protection that would be paid to the direct investor with an account with the failed firm. As a consequence, many indirect investors have criticized the restrictions on indirect investors as being unfair.[18] H.R. 5032 (Ackerman, 111th Congress),

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fund, through an intermediary fund or investment advisor cannot deduct losses under the safe harbor. However, the intermediary investment fund may itself qualify to claim theft losses under the safe harbor. The new procedure also provides guidance for taxpayers choosing not to use the safe harbor, but who plan to deduct investment fraud losses under the theft loss provisions of Section 165 of the Internal Revenue Code. Rev. Proc. 2009-20, 2009-14 I.R.B. (March 17, 2009). Available at http://www.irs.gov/irb/2009-14_IRB/ar11.html.

[14] This is taken from the Madoff trustee's website, located at http://www.madofftrustee.com/. The case is Bernard L. Madoff Investment No. 08-017890 (BRL) and the Securities Investor Protection Corporation v. Bernard L. Madoff Investment Securities LLC, available at http://www.madofftrustee.com/documents/ Net_Equity_Decision_3-1-10.pdf. In August 2010, attorneys for 700 Madoff investors asked the United States Court of Appeals in New York to reverse the March ruling, asserting that the judge erred in his opinion. Bloomberg, "Madoff Judge Erred in SIPC Ruling, Court Told," *InvestmentNews*, August 10, 2010, at http://www.investmentnews.com/ article/20100810/FREE/100819992. The Second Circuit Court of Appeals authorized an expedited appeal.

[15] For example, see "House Committee on Financial Services, Subcommittee on Capital Markets, Insurance and Government-Sponsored Enterprises Holds a Hearing on Securities Investor Protection Act Limitations," *Political/Congressional Transcript Wire*, September 23, 2010.

[16] In his December 9, 2009, statement before the House Financial Services Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, SEC Deputy Solicitor Michael Conley previewed the SEC's position that net equity for SIPC claims in the Madoff bankruptcy should be measured on a cash-in/cash-out basis, adjusted for the time value of money. "Statement Before the House Financial Services Capital Markets, Insurance, and Government Sponsored Enterprises Subcommittee by Michael A. Conley, Deputy Solicitor of the SEC," December 9, 2009, at http://www.sec.gov/news/testimony/2009/ts120909mac.htm.

[17] Raphael Minder, and Diana Henriques, "Overseas Madoff Investors Settle With Banks," *New York Times*, May 24, 2010.

[18] For example, see "Testimony of Peter J. Leveton, Co-Chairman of the Agile Funds Investor Committee, before the

which could be reintroduced in the 112th Congress, would have required SIPC to provide up to $100,000 worth of protection to indirect investors in "Ponzi schemes." This would have applied retroactively to trustees appointed to liquidate assets in previously discovered Ponzi schemes with customer investments totaling more than $1 billion, including the Madoff liquidation. To qualify for the benefit, the provision would require recipients to waive their right to sue a feeder fund, which some have said is unfair because the funds are presumed to have a fiduciary duty to exercise reasonable care for such investors and when they do not, investors should be able to retain the right to sue them. Moreover, while the bill would apply to the indirect investors of all such feeder funds, some criticize such an indiscriminate payout policy, arguing that SIPC's funds are limited and that payments to indirect investors should prioritize investors in smaller pension funds and other investment vehicles, which are often said to be the kind of feeder funds that have failed to inform the applicable broker-dealers of all of the individual accounts that they hold. Another criticism of providing such unqualified payouts to indirect investors is that some of the Madoff feeder funds appear to have been guilty of reckless behavior and failed to heed signals that there were problems at the company.[19]

Clawbacks. Under bankruptcy law, court-appointed bankruptcy trustees are entitled to "clawbacks," or recover, payments that were made out of a corrupt fund before the scheme was discovered and then return them to the bankruptcy estate for distribution to the scheme's victims. There are statutory limits on how far back a trustee can go in seeking such clawbacks. The court-appointed trustee in the Madoff case has been attempting to claw back funds from such investors, many of whom reportedly withdrew all of their funds from the operation years before Mr. Madoff's arrest.[20] This policy has been criticized by investors and by some members of Congress. Under H.R. 5032 (Ackerman), the trustee would have been prohibited from clawing back any money from victims unless the bilked investor was proven in bankruptcy court to be complicit or negligent in their participation in a Ponzi scheme. It would have also applied retroactively to trustees appointed to liquidate assets in discovered Ponzi schemes with total investments in excess of $1 billion, including the Madoff case.[21] In support of the status quo, John Coffee, Jr., a Columbia University law professor and a frequent panelist at congressional hearings, has spoken of the long-standing principle that investors who are aided or allowed by a fraudulent manager to

House Financial Service Committee's Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises Hearing," December 9, 2009, at http://www.house.gov/apps/list/hearing/financialsvcs_dem/leveton.pdf.

[19] For example, see "Testimony of Professor John C. Coffee, Jr., Adolf A. Berle Professor of Law Columbia University Law School before the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises of the Committee on Financial Services, United States House of Representatives," September 23, 2010, available at http://financialservices.house.gov/Media/file/hearings/111/Coffee092310.pdf. In the testimony, Professor Coffee also criticized the bill's definition of an indirect investor as "any person ... who is an investor in a Ponzi scheme investor...." He argued that "… this may work adequately when we are dealing with mutual funds or hedge funds, but it is unclear whether a pensioner under a pension fund is covered. Typically, a pensioner is not considered an 'investor' in the pension fund, and it would be desirable to include the pensioner in at least a defined contribution plan more explicitly…. [A] superior alternative to the [bill's] definition of 'customer' … could be expanded to cover a variety of beneficial or indirect holders on a 'pass through' basis. This is already the prevailing pattern under both the Federal Deposit Insurance Act (FDIA) and the Federal Credit Union Act (FCUA). Both these statutes allow for each beneficiary of a pension, profit-sharing plan, or individual retirement account to receive up to $100,000 of insurance coverage."

[20] Beth Hawkins, "Efforts to Recover Lost Funds from Ponzi Schemes Introduce New Legal Term to Public: Clawback," *Minnesota Post*, July 26, 2010, at http://www.minnpost.com/stories/2010/07/26/19933/efforts_to_recover_lost_funds_from_ponzi_schemes_introduce_new_legal_term_to_public_clawback.

[21] According to press reports, Rep. Gary Ackerman, the bill's sponsor, indicated that many of his New York constituents who were Madoff investors have been gouged by the clawback provision. Marcy Gordon, "Lawmakers Blast SIPC, Madoff Bankruptcy Trustee," *Associated Press*, December 9, 2009.

redeem their investments should not be allowed to benefit from their association with such a fraudulent entity. Professor Coffee has also indicated that under the existing bankruptcy code, the trustee can recover the payments made from a corrupt fund (which he calls "fictitious" profits), and place them in a fund whereby they will benefit all of a Ponzi's scheme's victims in a prorated fashion. He has also noted that the interests of net winners (investors who make profits from a Ponzi scheme) will conflict with net losers (investors who lose money from a Ponzi scheme). Thus, he argues that reform efforts such as H.R. 5032 that attempt to benefit net winners would invariably do so at the expense of net losers.[22]

The Stanford Case

In February 2009, the SEC charged Robert Allen Stanford and three of his companies with orchestrating a fraudulent, multi-billion dollar investment scheme centering on an $8 billion certificate of deposit (CD) program. Among Mr. Stanford's companies were the Antigua-based Stanford International Bank (SIB) and the Stanford Group Company (SGC), an investment adviser. The CDs were issued by SIB and marketed by SGC to investors worldwide, including to many Americans.[23]

SIPC officials have indicated that under SIPA, SIPC is obligated to repay up to certain amounts of accepted customer claims from failed broker-dealers when their securities are missing from the firm's accounts. However, according to the officials, the protection does not extend to investors who physically received their CDs, as was the case with the holders of the Stanford CDs.[24] The officials also noted that if fraudulent securities are issued by an SIPC non-member such as the Antigua-based SIB, no SIPC protection exists.[25] Finally, they observed that when securities are rendered worthless by fraudulent conduct, as was alleged in the Stanford case, SIPC provides no protection for loss of value.[26]

Many holders of the now virtually worthless Stanford CDs criticized as unfair SIPC's determination that they were not eligible for its protections. Several Stanford victims joined forces with Madoff's victims to lobby members of Congress for legislation aimed at improving SIPC's treatment of victims like them.[27]

The SIPC perspective that SIPA only authorizes it to cover the physical loss or theft of a security by a broker-dealer member, not a security's loss in value, has long been a source of controversy. Some observers note that the entrance of many relatively unsophisticated investors into the

[22] "Testimony of John C. Coffee, Jr. before the House Financial Services Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises hearing, Additional Reforms to the Securities Investor Protection Act," December 9, 2009. Professor Coffee did, however, suggest that possible reforms should redefine the criteria by which a clawback would be permitted from "whether the investor/creditor believed the 'assets in its account belonged to it' to whether it 'knew, or recklessly disregarded, facts indicating that the debtor was approaching insolvency."

[23] SEC, "SEC Charges R. Allen Stanford, Stanford International Bank for Multi-Billion Dollar Investment Scheme," press release, February 17, 2009, at http://www.sec.gov/news/press/2009/2009-26.htm.

[24] "Statement of Proposed Testimony of Stephen P. Harbeck, SIPC president and chief executive officer before the House Financial Services Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises," December 9, 2009.

[25] Ibid.

[26] Ibid.

[27] Robert Schmidt and Jesse Westbrook "Madoff Victims Join Stanford Investors to Lobby for Payback," *Bloomberg*, March 10, 2010, at http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aQMvceptRuSA.

securities markets appears to have led to increased brokerage fraud, which they say argues for broadening SIPC's mandate to include loss of value due to fraud.

The SIPC Modernization Task Force

In mid-2010, noting that the "last significant amendments to the Securities Investor Protection Act … were in 1980,"[28] SIPC formed a Modernization Task Force whose mission is to conduct a major review of SIPA.[29] The task force is chaired by SIPC's chairman and its vice chairman and includes representatives from the securities industry, investors, government regulators, and academia. Its specific duties are to propose to the SIPC Board "such statutory amendments, as may be necessary, useful, or appropriate, given the passage of time, changes in the securities industry, and judicial precedents construing SIPA."[30] The board is expected to review the task force's findings, conclusions, reports, and proposals with an eye toward possible legislative changes and other potential reforms to SIPA.

Major areas of concern for the task force include (1) the adequacy of the SIPC Fund, (2) no account claimants, (3) investor education,[31] (4) clawbacks and recovery issues, (5) the level of SIPC protection, (6) net equity, and (7) excess SIPC insurance.[32]

Dodd-Frank Wall Street Reform and Consumer Protection Act

The Dodd-Frank Wall Street Reform and Consumer Protection Act (P.L. 111-203, 124 Stat. 1376) was signed into law on July 21, 2010. The comprehensive financial regulatory reform law contains several provisions that amend SIPA and apply to all SIPA liquidations filed on or after July 22, 2010. The provisions are as follows:

- **Changes in the Minimum Assessment Amount.** Section 929V amends the minimum assessment amount for SIPC-member firms. The highest amount that

[28] The quote can be found at http://www.sipc.org/media/release17June10.cfm.

[29] The task force website is available at http://www.sipcmodernization.org/.

[30] Ibid. In a press release, Chairman Kanjorski referred to a March 4, 2010, letter to SIPC supporting the establishment of the task force, which the release reported was initiated by SIPC after "coming under intense scrutiny at a December [2009] hearing of the Capital Markets Subcommittee." Available at http://kanjorski.house.gov/index.php?option=com_content&task=view&id=1731&Itemid=1.

[31] One traditional area of focus with respect to SIPC and investor education has been apprising investors of the differences between SIPC protection and the FDIC insurance for depository institutions.

[32] As mentioned above, SIPC advances are limited to $500,000 per customer, of which up to $250,000 may be provided by SIPC to satisfy a claim for cash. Because of these limits, many large brokerage firms also purchase "excess SIPC" insurance products, which insure their customers for any losses in customer property above and beyond the distributions they would receive in a liquidation proceeding, including advances from SIPC. The number of claims for excess SIPC insurance have been very limited. Although the Lehman Brothers bankruptcy generated some excess SIPC insurance liability claims, only one other brokerage firm failure has produced another claim. Going forward, in a report to the SIPC board on excess insurance, a task force report posed three policy options and their likely implications: (1) stay with the current policy; (2) raise the limits of protection provided by SIPC, which would decrease claims for excess insurance, thus either making excess insurance cheaper, more profitable for insurance companies, or both; and (3) eliminate the current distinctions between cash and securities claims, a change that would eliminate some of the demand for excess insurance, at http://www.sipcmodernization.org/Topics/summary/05-04-10%20Excess%20SIPC%20Ins.FINAL.pdf. Many of the reports that the task force is generating for the SIPC Board are available at http://www.sipcmodernization.org/about_mtf.cfm.

- SIPC can impose as a minimum assessment is changed from $150 per annum to 0.02% of the gross revenues from the securities business of SIPC member.
- **Increases in the Line of Credit Available from the Treasury Department.** Section 929C increases the amount of money that SIPC can borrow from the Treasury Department (through the SEC) from $1 billion to $2.5 billion.
- **Increase in the Standard Maximum Cash Advance Amount for Each Customer.** Section 929H increases the amount of SIPC protection available for claims for cash from $100,000 to $250,000. Section 929H also provides that the amount of protection for cash claims may be indexed to inflation in accordance with the terms of the statute and with the approval of SIPC's Board.
- **Criminalization of Misrepresentation of SIPC Membership and Increase in Fines for Other Crimes Under SIPA.** Section 929V criminalizes the misrepresentation of SIPC membership by making such misrepresentation punishable by a fine of $250,000 or imprisonment for not more than five years. The maximum fine for other prohibited acts under SIPA is increased from $50,000 to $250,000.
- **Provision of SIPC Protection to Customers with Futures Contracts.** Section 983 amends the definition of a SIPC protected customer to include those with futures and options on futures in portfolio margin accounts carried as a securities account under a portfolio margining program approved by the SEC.

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